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State Income Tax Issues

TEI Los Angeles Chapter – Mergers & Acquisitions Seminar

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Agenda

- Introduction
- Income Tax Issues
    - Nexus Issues
    - Tax Base Issues
    - Apportionment Issues
- Practical Considerations

Introduction

- State income tax does not always follow federal income tax.
  - Seek the advice of state tax counsel early and often.
- Primary state tax issues to consider:
  - Nexus – which jurisdictions matter?
  - Internal Revenue Code ("IRC") conformity issues – can and do those jurisdictions conform to the federal income tax base provisions?
  - Group membership and unity – do the separate company, combined group, and state consolidated group differ from the federal reporting method?
  - Apportionment – how will the transaction affect apportionment percentages and methods?

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Nexus Issues
Which jurisdictions matter?

- Mergers and acquisition can create nexus in new jurisdictions for both acquiring companies and target companies.
  - Acquiring assets located in a jurisdiction where acquirer was not previously taxable.
    - May still be limits on the portion of the acquirer's income subject to tax.
  - Economic or attributional nexus
    - Even without tangible property located in a jurisdiction, there may be issues with nexus.
- *South Dakota v. Wayfair*, 558 U.S. ___ (2018)
  - Overturned *Quill Corp. v. North Dakota*, 504 U.S. 298, which required physical presence for sales and use tax collection obligations.
  - Although primarily a sales tax case, *Wayfair* may have implications for income tax nexus.
    - Approves of economic nexus thresholds
    - Approves of nexus creation based on location of customers

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Tax Base Issues
IRC Conformity

- State statutes often conform to federal taxable income (line 28 or line 30) as a starting point to calculate state taxable income.
- However, many issues can cause state tax bases to deviate from the federal tax base.
  - Rolling, static, or selective conformity
  - Separate, combined, or consolidated filing
  - State modifications
  - State-specific asset basis
  - Constitutional limitations on state taxation
- Issues with state tax compliance that happen each year can affect a later transaction.

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Tax Base Issues
IRC Conformity

- Examples affecting Mergers & Acquisitions in the Tax Cuts & Jobs Act ("TCJA"):
  - **Rolling, static, or selective conformity**: Does the state conform to the IRC before or after January 1, 2017 (the date most TCJA provisions took effect)?
    - States may enact specific statutes to conform to or deviate from the TCJA.
  - **Separate, combined, or consolidated reporting**: business interest deduction limited to 30% of federal Adjusted Taxable Income under IRC § 163(j).
    - For federal purposes, applies at the consolidated group level (proposed regs disregard payments between consolidated group members); indefinite carryforward of disallowed deductions.
    - Separate reporting states may apply the limit as if a corporation filed a separate federal tax return; group members may have state-level carryforwards that do not exist at the federal level.

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Tax Base Issues
IRC Conformity

- More examples affecting Mergers & Acquisitions in the TCJA:
  - **State modifications & state-specific asset basis**: the TCJA permits full expensing for the purchase of certain qualifying assets; taxpayers reduce asset basis by the amount of the expensing deduction.
    - States may use straight-line, MACRS/ACRS, bonus depreciation, or full expensing; depending on the historic deductions for depreciation or expensing, taxpayers may have different asset basis compared to federal.
  - **Constitutional limitations on state taxation:** GILTI and FDII provide special incentives and disincentives for operations located abroad, or domestic operations serving foreign markets.
    - Unlike the federal government, states are limited by the Foreign Commerce Clause.

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Tax Base Issues
338(h)(10) Transactions

- Under IRC § 338(h)(10), both buyer and seller may together elect to treat a stock sale as a "deemed asset sale."
  - A sale of the stock of a corporate subsidiary or an S corporation is treated as if the corporation had sold its assets and distributed the sale proceeds to its shareholders in liquidation.
- This permits the buyer of corporate stock to "step up" the asset basis of the target corporation's assets to the purchase price allocated to each asset.
- States generally conform to 338(h)(10) elections, but there are exceptions.
  - Gain on federal consolidated return may place tax burden on the buyer, but separate reporting states may place the burden on the seller, which can affect pricing. *Newell Window Furnishing, Inc. v. Comm'r of Rev.*, 311 S.W.3d 441 (Tenn. Ct. App. 2008).
  - California and Wisconsin allow state-specific elections for 338(h)(10).

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Tax Base Issues
Tax-Free Reorganizations

- State income taxes generally conform to the federal reorganization provisions, and a transaction that is a tax-free reorganization under IRC section 368 will be tax-free for state income tax purposes.
- However, deferred gains created or preserved during a tax-free reorganization can create issues.
  - Should the deferred gain be apportioned based on the company's presence when the gain is later triggered, or based on the company's presence at the transaction date? *See Matter of British Lands*, 85 N.Y.2d 139 (N.Y. 1995).

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Tax Base Issues
Spin-Offs

- Distributing subsidiary corporation stock subject to scrutiny regarding taxability under IRC § 355.
  - Under IRC § 355, each corporation must be engaged in an active business, a non-tax business purpose for the distribution must exist, and the distribution cannot be a device to distribute earnings and profits. IRC § 355.
- The states generally follow the federal treatment of spin-offs so a spin-off that qualifies under section 355 will generally be tax-free for state income tax purposes.

Tax Base Issues
Restructuring

- Internal restructurings typically involve stock and/or asset transfers that can have tax consequences.
- A corporation distributing assets to a parent corporation may be required to recognize gain under IRC § 311(b).
  - If the distributing and receiving corporation file as members of the same federal consolidate return, the consolidated return regulations turn off IRC § 311(b).
  - If the distributing corporation files in any separate reporting state, the distributing corporation may be required to prove they qualify for tax-free treatment under IRC § 355.

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Tax Base Issues
Net Operating Losses

- States frequently provide state-specific limits on the creation and use of NOLs.
- States may lack specific authority to transfer the target corporation's NOLs to the buyer in a tax-free reorganization (e.g., NOLs may be extinguished in the transaction). *See A.H. Robins Co., Inc. v. Director*, 182 N.J. 77 (2004).
- Case law may provide means to argue for the maintenance of a purchased company's NOLs. *See, e.g., Oliver's Laundry & Dry Cleaning Co. v. Ariz. State Tax Comm.*, 19 Ariz. App. 442, 508 P2d 107 (1973); *ThermatoolCorp. v. Dep't of Rev. Services*, 43 Conn. Sup 260, 651 A2d 763 (1994).
- Federal Separate Return Limitation Year ("SRLY") principles can apply at the state level, but apply in scenarios not relevant for federal tax purposes.
  - For example, a state combined group may change to include other previously non-unitary companies; SRLY limitations may apply even though the federal group did not change.

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Apportionment Issues
Unity

- The Unitary Business Principle – Now or Later?
  - Two effects: (1) “unitary” group composition; and (2) character of income.
  - Taxpayers must exhibit centralized management, functional integration, and economies of scale to conduct a “unitary business”.
  - Is there instant unity between a purchaser and target as of the day of the merger/acquisition?
    - Colorado: generally must wait three years
    - California: factors to consider to prove instant unity
    - New York: proposed regulations provide general rule (no instant unity) with exceptions
  - Statutory tests for combination may offer guidance.
  - Document pre-merger and post-merger activities to support position.

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Apportionment Issues
Character of Income

- A majority of states characterize income as "business income" or "nonbusiness income."
  - Sometimes called "apportionable" and "nonapportionable" income.
  - However, some states use a different framework (e.g., New York has "business," "investment," and "other exempt" income categories that are defined differently).
- Business income is subject to apportionment between the states where the company has nexus.
  - Multi-factor (property, payroll, sales) apportionment
  - Single sales factor apportionment
- Nonbusiness income is typically allocated to a single state.
  - Situs of tangible assets or commercial domicile of corporation
  - Arguments for credits or apportionment for allocated income?
- The benefits and detriments of income characterization vary for different taxpayers.

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Apportionment Issues
Character of Income

- For asset sales, courts have addressed whether income is "business" income in two ways: (1) the "transactional test; and (2) the "functional test."
- **Transactional Test**: Sale of property in the regular course of business produces business income.
- **Functional Test**: Sale of property that is used to produce business income (e.g., machinery) also produces business income.
  - The United States Supreme Court appears to have sanctioned the "functional" test if property sold is "unitary." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *MeadWestvaco Corp. v. Ill. Dep't of Rev.*, 553 U.S. 16 (2008); *see also Gannett Satellite Information Network Inc. v. Montana Dep't of Rev.*, 348 Mont. 333 (2009); *Welded Tube Co. v. Commonwealth*, 101 Pa. Commw. 32, 515 A.2d 988 (1986).
  - However, states may have cases holding that there is no functional test for certain asset sales. *See Western National Gas Co. v. McDonald*, 202 Kan. 98, 446 P.2d 781 (1968); *McVean & Barlow, Inc. v. N.M. Bur. Of Rev.*, 88 N.M. 521, 543 P.2d 489 (1975).

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Apportionment Issues Character of Income

- Liquidations may be treated as asset sales.
- Can be taxable (e.g., insolvent corporation) or non-taxable (liquidating distribution to another corporation).
- Fundamental issue to determine character of income from a liquidation: How are the proceeds used?
    - Is the business transferred and are the sale proceeds distributed to the shareholders? *Compare Glatfelter Pulpwood Co. v. Comm'n of Pa.*, 19 A.3d 572 (Pa. Comm. Ct. 2011) *with Elan Pharmaceuticals, Inc. v. Director, Div. of Tax* (N.J. Tax Ct. 2014).
    - Reinvestment of proceeds in a unitary business may prevent a "liquidation" for this purpose. *Century Tel, Inc. v. Dep't of Revenue* (Ore. Tax Ct. 2010).

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Apportionment Issues
Character of Income

- Stock sales involve similar issues to asset sales.
- The sale of a subsidiary engaged in a unitary business with the parent will produce business income. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992).
- However, the potential to conduct a unitary business is generally insufficient to produce business income. *See, e.g.*, CA F.T.B. Legal Ruling No. 2012-01 (Aug. 17, 2012).

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Apportionment Issues Factor Representation

- Can the seller in a major transaction include the receipts from the transaction in the sales factor?
  - "Occasional," "Casual," and "Incidental" sale rules vary by jurisdiction.
    - California: receipts from sale of fixed assets or other property excluded if exclusion results in five percent (5%) or greater decrease in the sales factor denominator and sale is outside the taxpayer's regular course of business and occurs infrequently.
  - Possible influx of income with no factor representation.
    - Compromise position: argue to include net receipts in the sales factor denominator.
    - Some states (Illinois, North Carolina) have provisions to include the net receipts from a transaction involving intangibles in the denominator.
- *Finnegan* vs. *Joyce*
  - Acquisition may result in higher tax liability for acquired company in certain states based on their *Finnegan* or *Joyce* approach to reporting.

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Practical Considerations

- Determine key states, both before and after a transaction, in advance.
- Develop checklist of SALT issues to consider.
  - Consider income and sales tax issues, as well as other issues (gross receipts, withholding).
- Vary the checklist for industry-specific and company-specific issues.
- Consider best case and worst case scenarios.
  - Compromise positions present opportunities to close audits without litigation.

Questions?

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